

ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED
JUL - 2 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
)
)

Implementation of Sections of)
the Cable Television Consumer)
Protection and Competition)
Act of 1992)
)
)

Rate Regulation)
)
)

MM Docket No. 92-266

REPLY COMMENTS OF
VIACOM INTERNATIONAL INC.

Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker

WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, DC 20006
(202) 429-7000

July 2, 1993

No. of Copies rec'd
List A B C D E

04

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	ii
I. INTRODUCTION	1
II. COMMENTERS SUPPORTING PUNITIVE FURTHER REDUCTIONS IN CABLE BENCHMARK RATES HAVE FAILED TO ESTABLISH THE LEGALITY OF EXCLUDING LOW PENETRATION SYSTEMS FROM THE COMMISSION'S BENCHMARK CALCULATION	4
III. VIACOM'S EXPERT ANALYSIS CONFIRMS THAT THE FCC'S BENCHMARK ANALYSIS IS FLAWED AND CANNOT SUPPORT FURTHER RATE REDUCTIONS	8
IV. CONCLUSION	12

SUMMARY

The Commission's Further Notice of Proposed Rulemaking in this proceeding proposes to exclude from the calculation of rate benchmarks "low penetration" cable systems, which would result in

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED

JUL - 2 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Implementation of Sections of)
the Cable Television Consumer)
Protection and Competition)
Act of 1992)

Rate Regulation)
_____)

MM Docket No. 92-266

REPLY COMMENTS OF
VIACOM INTERNATIONAL INC.

Viacom International Inc., by its attorneys, hereby submits this reply to the comments filed in response to the Commission's Further Notice of Proposed Rulemaking in the above-captioned proceeding.¹

I. INTRODUCTION

In the Further NPRM, the Commission proposes to exclude cable systems having less than 30 percent penetration of their service area from its calculation of the competitive rate differential. The Further NPRM notes that excluding such "low penetration" systems from the calculation would reduce the recently adopted competitive benchmark rates (already purportedly ten percent below current rates) by an additional 18 percent. For the reasons discussed below, Viacom believes that such an action would not be proper, either as a matter of law or policy.

¹ See 58 Fed. Reg. 29,769 (May 21, 1993) ("Further NPRM").

In its Further Comments,² Viacom demonstrated that the Commission lacks legal authority to exclude systems having less than 30 percent penetration when establishing its benchmark rates. Viacom pointed out that Congress had specifically adopted in Section 623(1)(1) of the Cable Television Consumer Protection and Competition Act of 1992 (the "1992 Cable Act") a precise definition of "effective competition" for purposes of regulating cable rates, and that an administrative agency such as this Commission may not adopt "a definition of a particular term that is at odds with a definition of that very term contained in the Act itself." American Civil Liberties Union v. FCC, 823 F.2d 1554, 1567 (D.C. Cir. 1987), cert. denied, 485 U.S. 959 (1988). The great majority of commenting parties agreed with Viacom that the Commission lacks the legal authority to modify the statutory definition.

Even if the Commission had discretion to exclude "low penetration" systems from the definition, the record also shows that an additional rate reduction at this point would be unwise as a matter of policy. While the minority of commenters favoring a further rate reduction did not address the effect of such an action, both the majority of commenters and, notably, a number of financial institutions emphasized the severe financial impact on

² Further Comments of Viacom International Inc. (June 17, 1993).

cable systems as a consequence of an additional rate rollback.³ Commenters also reported that the current rate regulations already appeared to be affecting directly the programming community. Cable operators have, since the April announcement of the new rate regulations, evinced little or no interest in acquiring new programming because the rate regulations provide them with little or no incentive to do so.⁴

In addition, several commenters have identified serious flaws in the Commission's underlying benchmark analysis and noted that, in view of these deficiencies, no further rate reductions could be justified. Viacom submits for the convenience of the Commission an economic analysis of the Commission's benchmark rate methodology prepared by Dr. James N. Dertouzos and Dr. Steven S. Wildman entitled "Regulatory Benchmarks for Cable Rates: A Review of the FCC Methodology," a copy of which is attached hereto.⁵ The Dertouzos & Wildman analysis, inter alia, rebuts certain contentions by advocates of further rate reductions that excluding "low penetration" systems would improve the Commission's calculation of competitive rate levels. Given

³ See Letter from Douglas B. Smith, the Bank of New York, and Thomas E. Carter, Nations Bank, to Secretary, FCC, MM Docket No. 92-266 (filed June 23, 1993) and attachment thereto.

⁴ See Comments of Discovery Communications, Inc. at 1-3 & 5-8 (June 17, 1993); see also Comments of Arizona Cable Television Association et al. at 11-12 (June 17, 1993).

⁵ This study is already a part of the record in this proceeding. See Attachment To Viacom International Inc. Petition for Reconsideration and Clarification (June 21, 1993).

the Commission may not implement the statute using a definition of a term "that is at odds with a definition of that very term contained in the Act itself." ACLU, 823 F.2d at 1567-68. Legislative history does not "trump clear and unambiguous statutory language." Id. at 1569.

Other commenters contend that the 1992 Cable Act grants the Commission such broad discretion in administering rate regulation that it can properly disregard low penetration systems on the grounds that such systems do not charge "competitive rates."⁷ Alternatively, based on speculation as to what Congress might have meant, they contend that while the Commission might have to "take into account" those systems, it can assign any weight it

The justification for engaging in such a redefinition is that the rates charged by systems subject to "effective competition" are only one of a number of factors Congress required the Commission to consider in setting rates, and, therefore, the Commission is free to discount or ignore low penetration systems.⁸ This argument has it precisely backwards. It is because Congress stipulated that the Commission must consider the rates charged by systems subject to "effective competition" as a factor in setting rate regulation standards that the agency is not free to ignore the rates charged by some of those systems.

Indeed, even if the Commission were at liberty to ignore Congress and substitute its judgment of what categories of cable systems charge sufficiently "competitive rates" -- a liberty which Viacom submits that the agency cannot take -- the agency, in order not to act arbitrarily and capriciously, would similarly have a duty to disregard systems meeting the other two statutory definitions of "effective competition" whose rates are "too low."⁹ Several parties have shown that it is error to presume that overbuild systems or systems facing municipal competition

⁸ See Further Comments of NATOA at 5.

⁹ See Comments of Time Warner Entertainment Company, L.P. at 11-17 (June 17, 1993); Comments of Tele-Communications, Inc. at 8-11 (June 17, 1993).

charge "competitive rates."¹⁰ If the Commission looks behind the definition of "effective competition" for purposes of excluding rates that are too high because they are not properly reflective of competition, it must also look behind the definition for purposes of excluding rates that are too low because they too are not reflective of competition.

In seeking to determine the rates charged by systems subject to "effective competition," the Commission may not exclude from its calculation the rates charged by an entire class of systems which Congress specifically defined as being exactly that -- subject to "effective competition." Rather than engaging in a legally questionable "hazardous tinkering"¹¹ with the statutory definition, the Commission should give full weight to low penetration systems in calculating the benchmark rates charged by systems subject to "effective competition," just as it gives full weight to non-compensatory and uneconomic rates that cable operators have been compelled to charge in response to pressure from "green mailing" overbuild systems and municipal systems not operated for profit.




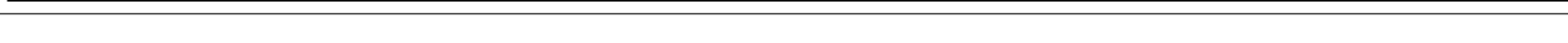






¹⁰ See Comments of the National Cable Television Association at 11 (June 17, 1993); Comments of the Coalition of Small System Operators at 3-4 (June 17, 1993). The Coalition observed that overbuild systems may have an incentive to price below costs, while systems owned by municipalities are not driven by market forces, such as profit incentives.

¹¹ Comments of the Massachusetts Cable Television Commission at 3 (June 17, 1993).

**III. VIACOM'S EXPERT ANALYSIS CONFIRMS THAT THE FCC'S
BENCHMARK ANALYSIS IS FLAWED AND CANNOT SUPPORT
FURTHER RATE REDUCTIONS**

Several commenters submitted economic analyses showing that serious problems exist with the benchmark methodology itself.¹² These problems raise substantial questions concerning the validity of the Commission's benchmark calculation for any purpose. At a minimum, however, the studies demonstrate that the Commission would be unwise in ordering further rate reductions as

Drs. Dertouzos and Wildman note that the methodology used by the Commission to derive its current benchmark formula fails to account for significant factors common to many cable systems that for one reason or another drive down rates but are independent of the existence of competition. Drs. Dertouzos and Wildman's



and Wildman demonstrate that cable systems in the overbuild situations identified by the Commission for its survey purposes "systematically differ" from all other franchises. The Commission's benchmark analysis does not, however, but should, consider whether these differences have any relevance to the presence of overbuild competition.

As the Dertouzos and Wildman study shows, overbuilds generally offer a larger number of both basic and cable network channels, have more advertising revenue and pay-per-view channels, and greater technological capabilities.¹⁵ In addition, overbuilds occur disproportionately in the South; although 28 percent of the industry's systems are located in the higher cost Pacific or Mountain regions, only three percent of the overbuild systems are located in those high-cost areas.¹⁶ As discussed in the Dertouzos and Wildman study, each of these "noncompetitive" factors independently or in combination has the effect of lowering basic and cable programming service rates.

For example, where a system offers a larger number of basic and cable network channels, the rate for each channel on a per-channel basis is lower than the per-channel rates charged by systems with fewer channels. Indeed, this is a predominant

¹⁵ See Dertouzos & Wildman at 10-11.

¹⁶ Id. at 11-12. Drs. Dertouzos and Wildman find that the benchmark calculation, by placing disproportionate weight on small, Southern rural areas, does not produce realistic compensatory rates for high cost, Western systems. Id. at 21-22.

characteristic of the current benchmark formula, but its relevance to the existence of an overbuild competitor or to competition itself is questionable. Lower per-channel rates charged by larger systems may well exist in the absence of actual competition. Yet, the Commission has assumed a causal link and has not accounted for the impact of the facts that larger systems can sell more advertising time, offer more pay-per-view, and are generally more technologically advanced than smaller systems. Each of these three elements allows for the earning of ancillary revenues that make up for the lower basic and cable network programming rates charged by these larger systems. Indeed, in order to maximize revenues by attracting advertising or by inducing subscribers to purchase high margin ancillary services, a large cable system has an economic incentive to lower basic and cable network service rates in order to obtain the widest possible subscriber base. The Commission has not accounted for this dynamic.

The prevalence of these factors in systems subject to competition, while being absent from the general population of systems not subject to competition, means that overbuild systems are not, in fact, representative of cable systems generally, and, therefore, cannot properly serve as a norm for setting "competitive rates." If anything, the Dertouzos and Wildman analysis shows that overbuild systems are no more representative


of rates engendered by the presence of an actual competitor than are low penetration or municipally-owned systems.¹⁷

IV. CONCLUSION

For the foregoing reasons and for the reasons stated in its Further Comments in this proceeding, Viacom International Inc. respectfully urges the Commission not to adopt the proposal in the Further NPRM to exclude the rates charged by "low penetration" systems subject to "effective competition" from its calculation of benchmark rates. Viacom submits that the Commission must not only, as a matter of law, include low penetration systems in its benchmark formula, but also do so as a matter of policy.

Respectfully submitted,

VIACOM INTERNATIONAL INC.

By: 
Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker

WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, DC 20006
(202) 429-7000

Its Attorneys

July 2, 1993

¹⁷ The Consumer Federation of America (see CFA Data Analysis at 2) concedes that municipal systems do not represent competitive rates because they generally are not managed to earn a profit. Accord Comments of NCTA at 11.

Regulatory Benchmarks for Cable Rates: A Review of the FCC Methodology

by

James N. Dertouzos

RAND Corporation

Steven S. Wildman

Northwestern University

June 21, 1993

I. Introduction

In the Cable Television Consumer Protection and Competition Act of 1992, Congress directed the FCC to develop and implement a regulatory strategy to ensure that all cable customers would receive the benefits of competition. To meet its oversight responsibilities with respect to the price of cable service, the Commission developed an econometric model of cable rates, which it used to develop: (1) a set of pricing benchmarks meant to capture systematic differences in the costs of providing cable services which would be accounted for in the pricing guidelines to be adhered to by system operators; and (2) estimates of the magnitude by which cable prices would be lowered by competition if it existed as defined in the Cable Act.

Under the Act, a cable system is assumed to be subject to effective competition within its franchise area if either of two conditions is satisfied:

That direct competition and other different factors which cause low penetration should be similar in their effects on cable prices cannot be demonstrated on theoretical grounds and can only be validated through empirical investigation. In a modified version of its original econometric model that separately examines the relationship between prices for basic service and low penetration and the different relationship between prices for services and head-to-head competition, the Commission found a much larger differential between (a) prices charged by non-competitive systems compared to prices charged by systems subject to competition by virtue of the presence of a second multi-channel distributor ("Overbuild Systems") than between (b) prices charged by non-competitive systems compared to prices charged by systems with less than 30 % penetration ("Low Penetration Systems"). Observing that low penetration may be "attributable to factors other than the presence of competing video distribution services,"¹ the Commission has asked for comment on whether only overbuild systems should be used to estimate competitive differentials.

In responding to the Commission's request for comment on this issue, we have found it necessary to consider the accuracy of the original analysis leading to a 10 percent competitive differential as well as the empirical methodology that produced that estimate. The intent of the Congress in writing the Act was that all cable subscribers enjoy the benefits of presumed competitive rates for cable service. Thus, with respect to the propriety of excluding Low Penetration Systems from the econometric model, the important question is not whether there are theoretical grounds for excluding them, but

¹ ¶560, Report and Order and Further Notice of Proposed Rulemaking released by the Commission on May 3, 1993.

whether the benchmarks generated when they are included in the model are reasonable estimates of competitive rates.

In addition to promoting the Congressional intent of securing economic efficiency and consumer welfare via competitive prices, the benchmarks must promote equity across the marketplace, absent compelling reasons to the contrary. That is, the resulting prices should allow for systematic differences between markets--in particular, the benchmark prices should reflect cost factors that are beyond the control of the cable operator.²

In Section II of this review, we replicate the FCC's model ("Model I") and estimates. Then we analyze the FCC's proposed methodology whereby Overbuild Systems would be separated from Low Penetration Systems, and we also analyzed the data set employed to generate the proposed benchmarks and estimates of competitive differentials. This analysis is then further extended in Section III wherein we conclude that the Commission's tentative finding of a 28 percent competitive effect is too large due to significant shortcomings in the FCC's underlying data and econometric model. Omitted variables that are highly correlated with the presence of overbuild competition are perhaps the most important source of bias which we found.³

²Of course, there are other important criteria for evaluating the merit of alternative benchmark methodologies. In particular, one must consider the inevitable costs of regulation and how they are affected by the adoption of alternative regulatory schemes. For example, one must consider the administrative burden, the cost of implementation, and the ability to monitor compliance. Allowance also must be made for potential economic distortions caused by cable operators who rationally will attempt to make the best of the new environment by changing their behavior. For example, one consequence of the new price constraints might well be less high-quality programming resulting from cable system operators negotiating lower license fees paid to programmers in order to make up for revenue losses experienced by operators due to the service rate rollbacks. Such economic consequences should be part of the social calculus in evaluating the efficacy of alternative regulatory approaches.

³For theoretical reasons, we also suspect that the weighted average of prices for different tiers that is used as the dependent variable in the Commission's

In Section III we also examine a second data set that includes many of the critical variables missing in the FCC data set. Using this data set to augment work with the FCC data set, we find that including Low Penetration Systems in the Commission's original study actually roughly offsets the shortcomings of problems with the Commission's original data and methodology. We believe that the true effect of overbuild competition on cable prices is close to the FCC's original 10 percent estimate even without inclusion of the Low Penetration Systems. In Section IV, we describe the implications of the FCC's proposed benchmarks if they exclude the Low Penetration Systems. In Section V, we conclude by exploring the equity and efficiency implications of employing the original benchmarks and 10 % estimates of competitive effects and make some suggestions for improvement in those original benchmarks.

II. The Methodology

At the heart of the FCC's methodology is an econometric model relating a franchise's average basic revenue per subscriber on a per channel basis (in logarithms) to four explanatory variables. These are the reciprocal of the system's number of subscribers, the log of the total number of channels offered on all basic tiers, the log of the total number of satellite channels offered on a system, and a "dummy" or dichotomous variable set equal to one when the system meets the Act's definition of effective competition. The FCC estimates that form the basis of the benchmark prices are reported in Table 1.

As shown by the Model I's (the FCC's original model) coefficient estimates, the average per channel fees were found to be negatively related to the size of the system, positively related to the number of satellite

estimating equation cannot be taken as a reliable index of the effects of competition.

programming services carried on the system, and negatively related to the total number of channels carried by the system.⁴ Most interesting from a policy perspective is the estimated effect of being in an effective competition situation. On average, systems with direct head-to-head competition and Low Penetration Systems have, by the FCC analysis, cable rates that are each about 9 % lower than the rest of the industry, all things being equal. To compute a benchmark price for a system not subject to effective competition, one merely computes the predicted price for a system with the same number of subscribers and channel offerings, and then reduces that price by .094 to reflect the level of rates that would prevail if the local market were competitive as defined by the statute.

Model II reports our attempts to replicate the FCC's results in Model I as reported above. Due to rounding error (the FCC provided a version of the data that had variable values that were truncated), our estimates are not identical to the FCC's--but the differences are minimal.

In Model III, we separated the competitive sample into two groups, the overbuilds and the Low Penetration Systems. With this model, the estimated rate effect for overbuild systems is dramatically different than in Model I and the estimates suggest that overbuilds result in about a 30 % decline in average cable rates. At the same time, the rates charged by Low Penetration Systems look no different from the rates charged by the rest of the industry not subject to competition. This parallels the results reported by the FCC for its use of this equation.

⁴ The interpretation of these coefficients is not straight-forward, because similar measures of channels carried are on both sides of the equation. Thus, the estimates can be loosely interpreted to suggest that the total monthly rate per subscriber (not expressed on a per channel basis) goes up by about 12 % when the number of channels offered is doubled.

Table 1
Comparison of Models Predicting
Basic Rates Per Channel

	Model I	Model II	Model III	Model IV	Model V
Intercept	2.445*	2.442*	2.296*	2.279*	2.537*
Effective Comp	-0.094*	-0.094*	--	--	--
Overbuild Sample	--	--	-0.294*	-0.240*	-0.237*
Under 30%	--	--	0.050	-0.004	-0.019
1/(System Subs)	7.345*	7.356*	6.502*	5.530*	10.900*
log(channels)	-0.888*	-0.888*	-0.866*	-0.805*	-0.599*
log(satellite)	0.100*	0.101*	0.129*	0.063	-0.121
Adj. R-squared	.63	.63	.67	.75	.59

* Significant at 95 %

Model I: FCC Benchmark Model

Model II: Replication of FCC Model, Using FCC Data

Model III: FCC Model and Data, Overbuilds and Under 30% Separated

Model IV: Removal of Outliers Indicating Data Inaccuracies

Model V: Estimation of FCC Model, Using NCTA Data

However, unlike the FCC we also estimated the model after eliminating sample observations that were identified as exerting inordinate influence on the parameter estimates.⁵ Certain variable values for these systems were clearly in error but still used in the FCC analysis. As a result, monthly cable rates as high as several hundred dollars or as low as a few pennies were

⁵About 5 % of the sample consisted of significant "outliers" having significant influence on the estimates of the model. We used standard SAS software for applying Cook's distance criterion for individual observation. Dennis R. Cook, "Detection of Influential Observations in Linear Regression," *Technometrics*, 19, 1977.

observed. The effect of removing this erroneous information is reported as Model IV. It is noted, however, that the qualitative nature of the results is unchanged. The estimated overbuild effect remains large, but lower at 24 %. Other coefficients change more dramatically. For example, the number of satellite channels is no longer significant and the importance of the number of subscribers falls.

Finally, we reestimated the FCC model using a data set collected by the National Cable Television Association.⁶ We performed this exercise both to test the reliability of the Commission's findings in Models I and II and to enable us to comfortably pursue additional analysis with the NCTA data set since it has certain advantages over the FCC data set (primarily the inclusion of several important explanatory variables). The results of the comparison are reported in Table 1 as Model V. Again, the estimates are quite similar. Most striking is the estimated effect on prices for overbuilds of 23.7%. This is close to Model IV, the model that does not utilize the portion of the sample that has obvious data discrepancies.

The larger estimated coefficient for the reciprocal of subscribers in Model V is due entirely to the greater prevalence of large systems in the NCTA data base. The restrictive functional form employed, which virtually guarantees that size economies disappear after about 1,000 subscribers,

⁶The Commission's data set is composed of a random sample (one percent) of the approximately 30,000 U. S. cable franchises plus extra observations from franchises of the 100 largest cable systems that is combined with a sample of franchises with either overbuild competition or single system penetration of less than 30%. For the final benchmark analysis, the larger system sample was excluded. Still, because systems having multiple franchises were more likely to be drawn, larger systems were sampled more frequently than would be expected based on their numerical prevalence. Alternatively, NCTA used a stratified sample to generate its data set, with higher weights placed on larger systems to ensure that they were sufficiently well represented in the data to make estimates of system size effects reliable for large systems. So, both procedures produced data sets in which large systems are over represented relative to their prevalence in the general population of cable systems.

evidently introduces some degree of statistical bias, primarily affecting smaller firms (but not the smallest ones).⁷

III. Implications of the FCC Methodology for Rate Benchmarks

In this section, we will discuss an important flaw in the underlying FCC methodology that seems to have led to benchmark levels that are inappropriately low. First, we will demonstrate that systems in overbuild situations are systematically different from all other franchises. These differences have nothing to do with the absence or presence of competition. This poses an econometric challenge because, unless the statistical model adequately takes such factors into account, differences in prices between overbuild franchises and other systems will be incorrectly attributed to the effect of overbuild competition. Because the FCC models do not account for such factors, there is strong reason to believe that the effects of competition are consequently overstated.⁸

A. Overestimating the Effects of Competition

The models employed by the FCC ignore potentially important factors affecting cable system prices. For example, there are no included variables which can accurately reflect factors known to affect cost (e.g., wage rates, utility taxes, population density). In addition, many of the omitted factors are highly correlated with the presence or absence of overbuild competition. Table 2 makes this quite clear.

⁷This is due to the fact that scale economies apparently continue for systems somewhat larger. This can be seen by the use of a different functional form or by allowing the coefficient on the subscriber variable to increase with firm size.

⁸In most of our analysis, we will be focusing on overbuild markets, how they differ from the rest of the industry, and the subsequent problems with estimating the competitive effects. However, we believe that implications for estimates of competitive effects for the joint sample of overbuilds and low penetration systems are similar.

Table 2
Comparison of Random Sample with Franchise Overbuilds

<u>Franchise Characteristic</u>	<u>Random Sample</u>	<u>Overbuilds</u>
Franchise Subscribers	3,148	4,676
System Subscribers	21,681	20,266
Systems > 20,000 Subs	24%	32%
Average Fees per Channel	.88	.53
Total Channels on Basic	29	38
Satellite Channels on Basic	18	24
Pay Channels	4	5
Churn (percent of subs)	53%	43%
Miles of Plant	66	177
Required to Bury Cable	19%	7%
Headend age :		
Under 6 years	24%	30%
Over 19 years	13%	20%
Basic Revenue % of Total	61%	53%
Located in South	30%	54%
Located in Pacific or Mountain State	28%	3%
6 or more Off-Air TV Signals	41%	71%
Member of large MSO (100 or more systems)	45%	24%

There are significant differences between the random sample and the overbuild sample. Although the average system size is similar, just over 20,000, the overbuild franchises are about 50% bigger at 4,676 subscribers. The average basic rate for the overbuild sample (representing about 16 percent of the 377 franchises included in the data) is .53, about 40 % lower